CHAPTER 1

Introduction to Hedge Fund Compliance

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INTRODUCTION

Nearly every profession, whether it is asset management, healthcare, construction, or scientific research, has some areas that require rules and regulations to be followed. At its most basic level, the term ***compliance*** refers to the processes and procedures by which an organization adheres to these guidelines. These guidelines may come from a variety of sources. Traditionally, the government is the primary initiator of compliance rules for different industries, but they may come from other sources as well.

Compliance has become a critically important component of investment management and this is particularly true in the hedge fund space. Key questions this book will seek to answer include:

- What exactly is hedge fund compliance?
- How can hedge funds design and improve their compliance function?
- What constitutes best practice compliance?
- What role do financial regulators play in implementing and monitoring compliance?
- Why should investors care about hedge fund compliance?
- What role can third-party service providers play in compliance?
- What global compliance trends are emerging in the hedge fund industry?

DIFFERENCES IN HEDGE FUND AND OTHER ALTERNATIVE FUND COMPLIANCE

Within the sphere of alternative investment fund managers, the lack of homogeneity creates a number of unique compliance challenges. Indeed, separate books could be written about the different compliance frameworks

required to address the intricacies of different alternative asset classes, such as real estate and private equity.

Hedge funds, too, are unique from a compliance perspective. In particular, they tend to be one of the more complex fund management entities. Why? For starters, let us clarify what the term *hedge fund* refers to. ***Hedge fund*** is a broad umbrella term used to classify many different types of managers that may be organized under differing fund legal structures. The broad nature of the term is one of the reasons that make the category of fund managers known as hedge funds unique and challenging from a compliance perspective. Other key reasons for the increased complexity of hedge fund compliance include:

- *Variety of different strategies employed*—Hedge funds utilize a number of different investing strategies. Common hedge fund trading strategies include global macro; long-short equity; market neutral; event-driven strategies, including merger arbitrage and special situations; convertible arbitrage; sector funds, including healthcare or energy funds; quantitative strategies; and even multistrategy funds. Although other types of alternative investment categories contain distinctions, the variety of investment strategies employed by hedge funds is relatively large in comparison.
- *Trading and operating on a global scale*—In many cases, hedge funds may conduct not only trading but also fund-structuring and asset-raising activities in multiple jurisdictions around the globe. This global landscape contributes to the complexity of the compliance environment surrounding hedge funds.
- *Wide range of instrument types traded*—To facilitate both the trading activities of a wide number of strategies, as well as the broad investment flexibility within different strategies, hedge funds often trade a wide variety of instruments. These can include equities; swaps; swaptions; forwards; futures; options; various types of bonds, including treasuries, convertible bonds, and catastrophe bonds; bankruptcy claims; syndicated loans, including bank debt, mortgage-backed securities, private investments in public equity (PIPES), repos, and reverse repos; commercial mortgage-backed securities (CMBS); and credit default swaps (CDS). The use of different strategies can-not only subject hedge funds to the oversight of different financial regulators and exchanges but the combined effect of utilizing multiple instruments also increases the complexity of administering compliance across various security types.

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- *Variety of trading implementation strategies*—To implement trading strategies, hedge funds may employ a wide variety of trading procedures. These may include variations on:
  i. Who is actually deciding to trade? (i.e., a human being, an automated computer trader, or some combination of the two)
  ii. The timing of trades—Are they spaced into the market over time or all at once?
  iii. The process of executing trades—Hedge funds may provide instructions to counterparties to execute trades in a number of different ways, including over the telephone or through electronic methods, such as instant message or e-mail. The reasons for this may depend on a number of factors, including the size of the hedge fund, the sophistication of a hedge fund's trading platform, the markets they trade in, and the way they work with trading counterparties. This variety presents a number of unique compliance challenges.
- *Use of multiple prime brokers and other counterparties*—***Prime brokers*** are companies that facilitate the implementation of a hedge fund's trading strategy. Companies that provide prime brokerage services are typically referred to as ***broker-dealers***. In their work with hedge funds, they typically offer hedge funds a number of services, including trade clearing, execution, and leverage financing. Today, it is common for hedge funds to utilize multiple prime brokers.

  Hedge funds do this for a variety of reasons, including diversifying their exposure across multiple counterparties as opposed to putting all of their eggs in one basket. The risk in using a single prime broker was highlighted after the 2008 failure of Lehman Brothers. There may also be other types of brokers utilized in addition to prime brokers. One example is brokers known as ***executing brokers***. These brokers typically work directly with prime brokers or, in some instances, directly with the funds, in executing trades. Another type of broker is called a ***futures commission merchant*** that facilitates trading in futures.

  Hedge funds may also utilize a number of other trading counterparties for securities, such as swaps. These swap counterparties are commonly referred to in the industry as **ISDA counterparties**. This name comes from the standard master agreement often used to implement these arrangements that is provided by the the International Swaps and Derivatives Association (ISDA).

  The use of these multiple prime brokers and counterparties often creates unique needs among hedge funds for specific compliance oversight of the ways in which they interact with these groups.

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- *Enhanced research techniques*—From an investment research perspective, hedge funds traditionally employ a relatively wide array of techniques as compared to other fund managers. These avenues may include research activities, such as discussion with industry experts, and the utilization of ***expert networks***. Expert networks are for-profit companies that organize databases of individuals with expertise in particular subjects or with particular companies. Expert networks then coordinate conversations between fund managers and these individuals in order to facilitate the fund manager's research. Accompanying the use of these research avenues are a series of additional layers of compliance oversight that would not otherwise be present in other alternative managers that do not engage in such techniques.

Each item listed above presents a specific set of compliance challenges that we will address in more detail throughout this book. The important takeaway at this stage is that, while there are certain core principles of compliance that can be applied across all asset classes, and within alternative investments in particular, based on the broad trading activities, strategies, and global scope of hedge funds, they present distinct compliance challenges that merit specialized compliance considerations.

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HEDGE FUND COMPLIANCE IS NOT SPECIFIC TO ONE COUNTRY

Compliance is a heavily rules-based exercise. These rules are driven by the laws and regulations of the different countries in which hedge funds operate. Although we will address certain key aspects of different hedge fund regulations in the major countries in which hedge funds operate, this book is meant to provide practical compliance advice on a global basis rather than focus too heavily on the laws of any specific country. There are many other more technical resources that can provide in-depth specific guidance on the applicable compliance laws in any particular country.

Regional Compliance Expertise Used by Hedge Funds

In practice, many hedge funds engage in business activities in multiple countries. It is not practical for these hedge funds to maintain internal compliance experts who have expertise in all of the countries in which they may operate. To solve this problem, a hedge fund's interpretation and implementation of compliance guidelines in different countries often comes about as a result of consultation with a number of different country-specific specialists.

To clarify some terminology, individuals or firms that are not employees of the hedge fund but provide services to it are commonly referred to as

third parties, ***third-party firms***, or ***service providers***. Although not every service provider provides compliance-related services to a hedge fund, many do in one form or another. One of the most common compliance-focused service providers is known as a ***compliance consultant***. Another type of hedge fund service provider heavily involved in compliance is a ***law firm***, which is also sometimes referred to as a hedge fund's ***legal counsel***. The country-specific compliance specialists that hedge funds heavily rely on in the compliance area are typically either compliance consultants or legal counsel.

Another reason that many hedge funds utilize third-party compliance consultants when operating in different countries is because compliance is an evolving subject. As the laws and rules in different countries change, external expertise can often provide valuable insight into trends in compliance practices in specific countries.

Benefits to Developing a Global Understanding of Compliance

When studying the area of hedge fund compliance, there are benefits toward first establishing a general understanding of the subject on a global basis before delving too deeply into the rules of any one country. From the perspective of hedge fund employees, while individuals who are experts in the compliance practices of any single country are, of course, valuable, developing a global understanding of general compliance policies coupled with third-party country or region-specific compliance expertise as needed often produces a much more holistic compliance program.

From the perspective of hedge fund investors seeking to evaluate hedge fund compliance protocols, first developing a more general understanding of core hedge fund compliance principles prior to any country-specific knowledge is also advisable. This is because investors may allocate capital to hedge funds in multiple jurisdictions, which are subject to different compliance regimes. By developing this general compliance foundation first, which is then complemented by country-specific compliance knowledge, a more universal compliance due diligence program for investors will result.

Keeping both the hedge fund employee and the hedge fund investor perspectives in mind should assist you as you work through the material.

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DO ALTERNATIVE INVESTMENTS MERIT SPECIAL COMPLIANCE CONSIDERATIONS?

Hedge funds are commonly grouped into an asset class known as ***alternative investments***. Alternative investments differ from other types of investments, such as long-only mutual funds, commonly referred to as ***traditional investments***. For reference, a ***long-only fund*** is one that only engages in the

purchasing and selling of investments, such as buying or selling equities. These are long-only investments because the fund's general strategy is to make long-term predictions that the value of the investments will increase over time. Long-only funds do not follow a strategy of selecting investments by betting that the value of certain investments will decrease over time.

By contrast, an approach that seeks to profit from the decline in value of a potential investment, such as betting for a decline in the price of the shares of a publicly traded company, is known as ***short selling.*** Short selling is typically carried out through the use of equity options. One hedge fund strategy that combined both long- and short-selling techniques is known as a ***long-short strategy***. In addition, other hedge fund strategies may also typically involve the use of options and other short-selling techniques. Other common types of alternative investments, often grouped alongside hedge funds in this category, are private equity, real estate, and commodity funds.

Within the area of fund manager compliance, the question may be raised whether alternative investment managers merit special compliance considerations as compared to traditional investment managers. When we refer to a ***fund manager***, unless otherwise stated, we are not referring to a specific individual, such as a portfolio manager, but rather to the management company organization for which an individual known as a fund manager or portfolio manager typically works. Prior to answering the question of whether a special classification category is required for hedge funds, we must first understand the notion of market and regulatory classifications.

Contrasting Regulatory and Market Classifications

Most regulators have big categories by which they categorize similar types of financial entities. This is in contrast to the smaller distinctions among different types of asset managers that may be made in the real-world marketplace. When it comes to hedge funds, the majority of global financial regulations do not maintain a separate classification for entities that may be classified as a hedge fund, private equity fund, or any other alternative investment vehicle. Instead, within the broad umbrella of regulatory fund manager entities, financial regulations are primarily more driven by the activities of these fund managers. This concept highlights the distinction between what may be referred to as a ***regulatory classification*** and a ***market classification*** of a fund manager.

Understanding Regulatory Classifications A regulatory classification is the way a fund manager would be classified based on predetermined regulatory classification requirements. One way to think about regulatory classifications is the way in which a fund manager is viewed from a legal perspective.

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For example, in the United States, if a fund manager under the ***Investment Advisers Act of 1940*** (Advisers Act, or Act) and accompanying statutes meets certain specific criteria, then the manager is classified as an entity known as an ***Investment Adviser***. In general, Section 202(a)(11) of the Advisers Act defines an "Investment Adviser" as any person or firm that:

> *(1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities.*[1]

As you can see by these general criteria, the requirements are quite broad. This means that whether an organization is a long-only mutual fund or a long-short hedge fund manager, from a regulatory perspective, they are both Investment Advisers.

If an organization does not meet each criterion and isn't exempt for some other reason, then the manager is generally not classified as an Investment Adviser. Why does this classification matter? If a fund manager is not an Investment Adviser, then it would generally not have to register with the U.S. Securities and Exchange Commission (SEC). More specifically, the compliance programs of a registered hedge fund may be distinctively different from an unregistered fund.

Understanding Market Classifications A market classification is the way a fund chooses to portray itself in the market. Alternatively, it can be the way a fund is classified, typically by investors, based on its actual trading activities. Obviously, it is not in a hedge fund manager's interest to misclassify their activities, but sometimes these two classifications are the same, and in some cases, there may be differences in classification methods, depending on the classification requirements in place.

Market classifications can be contrasted from regulation classification in two primary ways. First, under market classifications, there are no bright-line criteria determining what constitutes one classification type (i.e., a global macro hedge fund) from another (i.e., an event-driven hedge fund). For reference, a ***global macro hedge fund*** is a fund that follows a strategy of investing in macroeconomic themes, typically utilizing a wide variety of financial instruments on a global basis. An ***event-driven hedge fund*** follows a strategy of investing around the occurrence of certain events, such as corporate mergers or litigation.

Second, there are not necessarily any specific requirements, legal or otherwise, imposed on a manager for labeling themselves, or being labeled, under a market classification. This is in stark contrast to regulatory classification, which can have a material impact on the activities of a fund manager.

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<u>Example of Market and Regulatory Classification Differences.</u> To make the distinction between regulatory and market classifications more concrete, let us consider an example. Consider a U.S.-based fund manager that chooses to promote itself to potential investors as a hedge fund. This would be the market classification from the hedge fund's perspective. A potential investor may take a look at the fund manager's actual, or planned, investment activities and instead classify the fund under a more detailed classification of a global macro hedge fund. This would be an example of how the market classifications can differ, or at least be more specific, between the fund itself and the investor.

As noted earlier, there is no specific regulatory classification for hedge funds, so the fund cannot have the same market and regulatory classification in this case. What would the regulatory classification be? If we focus on just U.S. regulatory classifications, and not any other jurisdictions, and it is a U.S.-based hedge fund that meets the SEC requirements outlined earlier, then its regulatory classification would be that of an Investment Adviser. As this example demonstrates, a hedge fund, therefore, can be correctly referred to as being in different market or regulatory categories, depending on the specific classification system in place.

When discussing hedge fund compliance, the regulatory classification is typically the driving force over market classifications, as regulatory classifications facilitate the heart of the compliance guidelines that a hedge fund must adhere to. However, it is important to understand the concept of market classification so that the appropriate distinctions can be made between the two classification systems.

<u>Example of multiple regulatory classifications.</u> In the previous example, we alluded to the fact that a hedge fund may have multiple regulatory classifications. One reason for this multiple regulatory classification system is because a hedge fund may be subject to multiple regulatory agencies. To be clear, these classifications may come within the same country or across multiple countries.

In some cases, this oversight is driven by a hedge fund's trading activities. For example, certain hedge funds may engage in the trading of a type of security known as ***commodity futures***. A commodity future is a security that allows a hedge fund to speculate on the future price of commodities, such as lean hogs, coffee, cocoa, and copper. In the United States, if a hedge fund were to engage in futures transactions, they would be regulated by the joint efforts of two different regulators known as the National Futures Association (NFA) and Commodity Futures Trading Commission (CFTC). The NFA is a type of agency known as a self-regulatory organization (SRO), whereas the CFTC is a federal regulatory agency. SROs will be covered in more detail in Chapter 2.

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As part of this oversight by the CFTC and the NFA, a hedge fund may have to register under special regulatory classifications similar to the SEC's Investment Adviser category. Common classifications under the CFTC and NFA regimes are for a fund manager to register as a ***Commodity Trading Advisor*** (CTA), a ***Commodity Pool Operator*** (CPO), or perhaps as both.

UNDERSTANDING THE HEDGE FUND COMPLIANCE FRAMEWORK

With an understanding of why hedge funds present unique compliance challenges, we can begin to introduce more specifics related to the way compliance is approached in hedge funds. To do this, we will first analyze the makeup of a hedge fund's compliance framework. This will be followed by an introduction of the hedge fund compliance function. Last, the key parties in a hedge fund's compliance framework will be discussed.

A hedge fund's compliance framework is not just the compliance function within the hedge fund itself. This is a common point of confusion among investors in particular. While certainly, the heavy lifting is performed by the compliance function, there are also other elements within the hedge fund that perform compliance-related functions. Furthermore, outside of the hedge fund, there are a number of service providers and counterparties that also perform compliance-related functions. This relationship is summarized in Exhibit 1.1.

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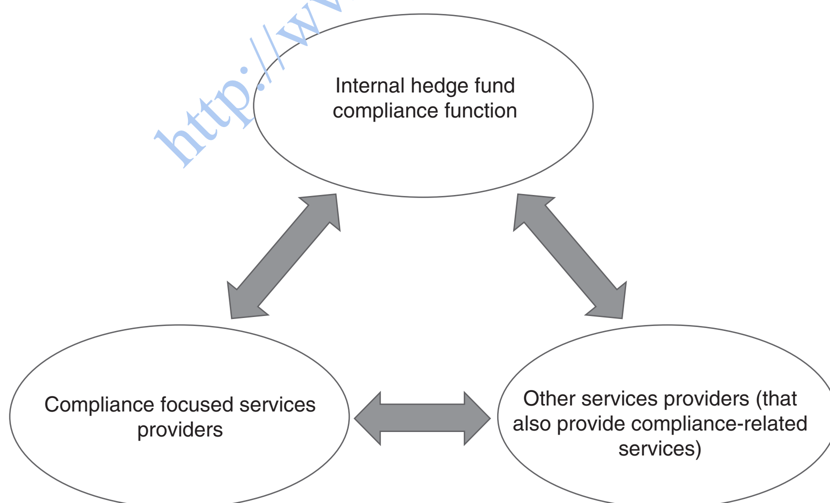

EXHIBIT 1.1 Components of a Common Hedge Fund Compliance Framework

Therefore, to fully understand the entire hedge fund compliance playing field, we must look beyond the compliance function within the hedge fund to analyze all of the key compliance stakeholders, both inside and outside the fund.

INTRODUCTION TO THE HEDGE FUND COMPLIANCE FUNCTION

The hedge fund ***compliance function***, or ***compliance department***, refers to a group within the hedge fund whose responsibility is to develop, implement, maintain, and test compliance policies and procedures. The compliance function often sits alongside other operational groups, such as fund accounting or technology.

One structure for a hedge fund compliance department is a ***dedicated compliance function***. Under this structure, the compliance function only focuses on compliance-related tasks. This is in contrast to a ***shared compliance function*** structure, in which the compliance function may be combined with other departments within the hedge funds. A common structure for a hedge fund with a dedicated compliance function is outlined in Exhibit 1.2.

In a perfect world, every hedge fund would have enough resources to devote to developing a stand-alone dedicated compliance function (see Exhibit 1.2). In practice, for a number of reasons, including resource constraints, this is not always the case.

Employees who work in the compliance function may be shared among different groups and have multiple responsibilities. We will address the pros and cons regarding these different compliance structures in subsequent chapters. For now, the important thing to remember is regardless of whether

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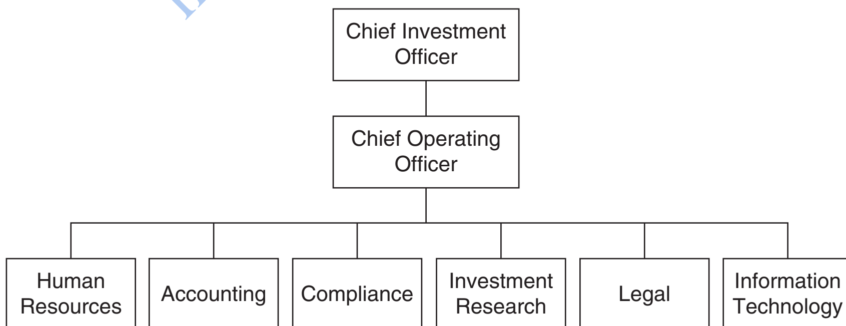

EXHIBIT 1.2 Example Organizational Structure of a Hedge Fund with a Dedicated Compliance Function

compliance department employees are shared, there will be individuals within the hedge fund who have a duty, in one form or another, to oversee compliance.

DISTINGUISHING THE LEGAL AND COMPLIANCE DEPARTMENTS

As Exhibit 1.2 demonstrates, a hedge fund may maintain both a legal and a compliance department. While these two departments may overlap with each other, they generally have different goals.

In other cases, a hedge fund may combine the legal and compliance functions into a single department. Reasons for this can include resource constraints on the hedge fund and a desire to centralize the responsibilities of certain individuals within the hedge fund. The two functions overlap to some extent, and combining them can represent a practical use of hedge fund personnel in certain instances.

The Legal Department Function

As can be expected, the legal function of a hedge fund is traditionally focused around tasks surrounding more legal, as opposed to compliance, matters. These legal tasks can cover a wide area. Common legal tasks performed by hedge funds typically include:

- *Traditional contract work*—Similar to many other businesses and fund managers, hedge funds engage in legal contracts, including employment contracts with senior personnel, rental agreements for office space, and vendor and service provider contracts. The legal tasks related to these contracts include drafting, reviewing, and negotiating contracts a hedge fund may enter into with a variety of parties.
- *Litigation management*—Hedge funds may sometimes be involved in lawsuits. These lawsuits may be initiated for a wide variety of reasons, including
  - **a.** *Portfolio-related litigation*—Sometimes a hedge fund will initiate, or participate, in legal proceedings as part of the its investment strategy.
  - **b.** *Employment related litigation*—Disputes may arise between a hedge fund and its employees, which includes direct employees of the fund as well as any consultants or other classes or individuals to which a hedge fund may maintain an employment obligation. These types of lawsuits can be broken up into two primary categories. The first category would be suits brought by the fund manager. The second would be those brought by employees.

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- *Third-party law-firm management*—Hedge funds often work with third-party law firms to assist in a variety of legal matters, including those referenced earlier. A common internal legal task at a hedge fund is managing the work of these third-party firms.

Related but Not Equivalent

The legal and compliance functions of a hedge fund are often thought of as being related departments because a number of similarities exist between the two groups. There are several reasons for this, including

- Traditional shared coverage of both functions—The head of the legal function is commonly given the title of **General Counsel**, while the compliance function head is commonly referred to as the **Chief Compliance Officer**. Although not every hedge fund maintains a general counsel, historically the General Counsel at a hedge fund would have also maintained responsibilities for compliance-related functions. For example, it might not be uncommon for an individual with the title of General Counsel to also hold the title of Chief Compliance Officer.
- Shared basis in the law—Compliance and legal functions are both rooted in the law and legal principles; hence, the overlap among the functions.
- Complementary functions—The compliance and legal functions may be subject to oversight by each other in certain areas. For example, the activities of a hedge fund's legal department employees are typically subject to compliance oversight. Similarly, the development of compliance materials may require input from those with specialized legal expertise, which may come from the legal department.

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So, while the hedge fund's legal and compliance functions overlap to a certain degree, the specific duties and goals are different—they are related but not equivalent.

KEY PLAYERS IN COMPLIANCE

A hedge fund's compliance efforts may be primarily driven by internal personnel. When this is the case, there are various individuals and groups that may be involved in the compliance function including those outlined below:

- *Chief Compliance Officer (CCO)*—The most prominent compliance professional is the Chief Compliance Officer. In addition to leading the compliance function, the CCO fulfills regulatory requirements.

Specifically, many regulators around the world require hedge funds to designate a CCO.

In addition, the CCO typically assists a hedge fund in complying with a number of other regulatory duties, including filing regulatory reports, developing compliance policies and managing daily compliance audit calendars. The CCO position is discussed in more detail in Chapter 3.

- *Additional compliance personnel*—Similar to the CCO role, other compliance individuals may or may not be dedicated to compliance functions. Although the CCO position is mandated by regulators, other positions are not, and a fund may not have any other additional compliance employees. If this is the case, the CCO may perform all essential compliance functions themselves, or those tasks are outsourced, such as to a compliance consultant.
- *Shared compliance employee*—A ***shared compliance employee*** is an individual who performs certain compliance duties in addition to other responsibilities outside of the compliance function.

  Consider an example of a compliance department that is made up of six people, five of whom work solely on compliance-related tasks. The sixth person spends part of their time on compliance duties and the rest on noncompliance tasks, such as fund accounting. Under this structure, the compliance department may be referred to as either dedicated with supporting resources or a ***mixed compliance department***.
- *Noncompliance personnel*—Noncompliance personnel perform jobs in which compliance matters are not part of their daily activities. These individuals include everyone from investment professionals to fund accounting personnel. This does not mean they ignore the compliance function, but they do not focus on it as part of their regular duties.
- *Compliance consultants*—Compliance consultants are third-party firms that provide advice on compliance-related matters to hedge funds. Their services range from completely running a hedge fund's compliance function to compliance policy development and assisting hedge funds with ongoing compliance management. It is not a requirement for hedge funds to maintain a compliance consultant, and not every hedge fund will have one. The roles of compliance consultants are discussed in more detail in Chapter 6.
- *Other compliance-related service providers*—Other third-party service providers can focus more on supporting the infrastructure of the hedge fund, such as information technology consultants and utility companies. Although third-party service providers are not focused exclusively on compliance, they do perform compliance-related services. These other service providers are also discussed in more detail in Chapter 6.

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STANDARD AREAS COVERED BY A HEDGE FUND COMPLIANCE FUNCTION

At this point in the reading, several basic compliance concepts have been introduced, and the structure of compliance departments has been discussed. We can now turn our attention to the key areas covered by compliance.

Standard Areas Covered by a Hedge Fund Compliance Function

At a very basic level, hedge fund compliance can be divided into two coverage areas: investment-related and non-investment-related compliance areas.

- **Investment-related compliance areas.** These areas directly relate to the investment management business of the hedge fund organization. Traditionally, this is where the majority of hedge fund compliance efforts are centered.

  Take, for example, trade allocation, in which a hedge fund manages two different funds that adhere to primarily the same investment strategy. Each fund has been created to accommodate the tax needs of different types of clients (onshore and offshore). When funds are managed in this structure they are said to be managed in what is known as a ***pari passu manner***.[2] One fund is structured for clients who are typically based in the same country as the headquarters of the hedge fund. This is known as the ***onshore fund***. The other fund is for investors based outside of the primary country in which the hedge fund operates. This is known as the ***offshore fund***. Funds organized in this manner typically are structured to sit beneath what is known as a ***master fund*** that coordinates the underlying funds trading activities. In this structure, the onshore and offshore fund would be referred to as ***feeder funds***, and the entire fund complex would be a ***master-feeder structure***. Assume that our master fund makes a single purchase of 100 shares of Google stock. Typically, the stock would not remain at the master fund and would need to be allocated between the onshore and offshore feeder funds. But how should this allocation be completed? You might think it would be easiest to split the shares 50–50 among the two funds. Perhaps, however, the onshore fund contributed more of the capital to make the purchase happen and trade should be allocated in a method known as ***pro-rata trade allocation***, which means that the trades should be allocated proportionally. Or what if the fund manager intended to buy more shares, or perhaps even all of the shares just for the onshore fund alone?

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Alternatively, consider whether the performance of the offshore fund has been slightly worse as compared to the onshore fund. If this is a winning trade, then perhaps the fund manager would wish to boost the performance of this poor performing fund by allocating more shares to it. While benefiting the offshore investors, this would disadvantage the onshore investors.

It is the role of a hedge fund's compliance function to design the policies with regard to the way trades are allocated and to oversee the implementation of these policies in conjunction with investment personnel. In such an example, the compliance function would be tasked with playing an active role in overseeing that the allocation of trades among the funds is conducted in an manner that does not unfairly disadvantage the funds investors and complies with regulatory guidelines as well as the fund managers own internal policies.

- **Non-investment-related compliance areas**. These are areas where compliance policies and procedures relate to more operationally focused areas, such as guidelines and oversight governing the travel, gifts, and entertainment given to and received by the employees. A business development representative may travel to a conference to meet prospective clients. While this capital, if raised, will be utilized in the investment process, the actual travel and the raising of the capital does not directly relate to the day-to-day investments made by the fund. Therefore, it could be said that this type of compliance is in the non-investment-related compliance category.

  Compliance plays a role in overseeing these types of activities. For example, if the prospective client is a government employee, there may be limits to the value of any gifts or meals they are allowed to receive. Similarly, to avoid gaining undue influence by service providers through lavish gifts, a hedge fund's own internal compliance policies may limit the value of gifts its own employees can receive.
- **Practical firm-wide compliance approaches**. In practice, the design of a successful hedge fund compliance management program does not place too much emphasis on the distinction between investment and operational compliance. Rather, the focus is on ensuring that all compliance policies and procedures, be they investment or noninvestment, are complied with. The distinction between the two is an important one to keep in mind however, from the perspective of implementing and managing the compliance function.

  For example, consider a growing hedge fund undertaking an upgrade to its information technology, or IT, infrastructure. Although it is an operationally intensive project that may not necessarily be directly related to the investment work of the funds, certain aspects of

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investment-related systems, such as trading platforms used at the hedge fund, may change. Compliance oversight of this mostly operational project would likely need to keep in mind certain investment-related compliance requirements of the system upgrade. By keeping in mind the distinction and interrelatedness of operational noncompliance and compliance areas, a better design and management of the overall compliance infrastructure can be implemented.

This framework of the areas covered within the compliance function will be discussed in more detail in later chapters.

COMPLIANCE FUNCTION ROLES AND AUTHORITY

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Compliance is a pervasive subject involved in all areas of the business of the hedge fund. The role and authority level of the compliance function, however, may differ, depending on the specific area of the hedge fund in question.

Although compliance dictates a majority of permissible and forbidden activities, there are many areas of a fund's activities that it may not necessarily address. Consider a hedge fund's management of fund expenses. There are few, if any, concrete regulatory guidelines about what constitutes an acceptable level of fund expenses. Similarly, there are a lack of guidelines about what actual expenses may be charged to the fund as long as hedge funds are transparent to their investors regarding what expenses are incurred. In practice, this is a decision typically made at the management level, and hedge funds often give themselves a large amount of leeway in setting their own expense guidelines. The compliance function, in conjunction with other service providers, such as auditors, are primarily focused on ensuring that the hedge fund does not violate its own policy in this regard rather than dictating what would be appropriate or best for the fund and its investors. In such circumstances, the job of the compliance function is often to serve as the enforcer of rules as opposed to an adviser helping to design them.

A related example would be an expense for a hedge fund that purchased a new computer server for its office. This server will be used by multiple departments within the firm for a wide variety of purposes, ranging from marketing and fund-raising for several different funds to storing data related to the investment management of a particular fund. Who decides what percentage of the cost of the server, if any, should be charged to a specific fund?

A hedge fund's own guidelines are likely to be vague and to provide management with a certain amount of discretion. So, if a manager decides to allocate 40 percent of the server to a single fund as compared to 30 percent,

who is to say whether they are correct? In cases such as this, the decision about how much to charge a particular fund for the use of a server is often more of a business decision rather than a compliance one. The compliance function would oversee the choice that was made but not generally make the decision on the allocation.

As demonstrated by the expense management example above, when evaluating a compliance function, both hedge fund employees and investors should consider the flexibility afforded by policies. This type of analysis can help determine whether or not a fund's compliance program is designed too malleable, or rigid, to be effective.

CHAPTER SUMMARY

In this chapter, we began by outlining the concept that alternative investments merit special compliance consideration. We summarized the reasons that hedge funds are different from other types of alternative investments from a compliance perspective. Next, a distinction was made between market and regulatory compliance classifications. We then provided an introduction to the structure of compliance departments and distinguished between the legal and compliance functions. The key personnel and service providers that play a role in hedge funds compliance were then discussed. Finally, we provided an introduction to key investment and operational areas covered by compliance.

With this foundation in place, the next chapter will provide a more detailed overview of regulatory compliance with a focus on regulatory trends in popular hedge fund jurisdictions, including the United States and the United Kingdom.

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NOTES

1. U.S. Securities and Exchange Commission. *General Information on the Regulation of Investment Advisers*, www.sec.gov/divisions/investment/iaregulation/memoia.htm.
2. Jason Scharfman, *Hedge Fund Operational Due Diligence: Understanding the Risks* (Hoboken, NJ: Wiley Finance, 2008).